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No. 89-1999

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

DIEBOLD, INCORPORATED,
Petitioner,
v.

UNITED STATES,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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REPLY MEMORANDUM FOR THE PETITIONER

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In our petition for certiorari (hereafter "Pet."), we noted that this case presents the basic question whether a taxpayer changes his "method of accounting" for purposes of the Internal Revenue Code when he corrects a substantive error that would have been improper under *any* set of accounting procedures.[1] We explained that the decision below, by holding that it is "irrelevant" whether the practice to be corrected would have been improper under all circumstances, conflicts with decisions of other federal courts of appeals and the United States Tax

[1] *See* Pet. ii for compliance with Rule 29.1.

Court. Pet. 5-11. We also argued that the decision below expands the power of the Commission beyond what Congress intended and improperly curtails the right of taxpayers to amend their returns and to file claims for refund. Pet. 12-14.

In its brief in opposition (hereafter "Br. Opp."), the government does not directly defend the court of appeals' ruling that it is irrelevant whether the practice to be corrected would have been improper under any set of accounting procedures. Rather, the government contends (1) that the change at issue here "easily falls within the plain terms of the provisions of the regulations," Br. Opp. 6; (2) that the courts have repeatedly recognized that IRC § 446(e) applies to a change "from an impermissible or improper method of accounting to a permissible or proper one," Br. Opp. 8; and (3) that the decision below does not conflict with decisions of other courts, Br. Opp. 9-11. As demonstrated below, none of the government's contentions has merit.

1. Focusing on the particular correction involved in this case, the government contends that the court of appeals reached the correct result because "the change at issue here—from inventory to depreciable assets—easily falls within the plain terms of the provisions of the regulations." Br. Opp. 6. In support of that contention, the government cites an example given in Treas. Reg. § 1.446-1(e)(2)(ii)(b). Br. Opp. 6.

The example in question is inapposite. It involved not a change from inventory to depreciable assets, but a change from expensing an item to depreciating it. Unlike the former change, the latter change clearly is one "which involves the proper time for . . . the taking of a deduction." Treas. Reg. § 1.446-1(e)(2)(ii)(a). Depreciation as a capital asset and treatment as a current expense both involve deductions from gross income. The very difference between depreciation deductions over several years and deduction as a current expense in a single

year is the time for taking the deduction (ratably over several years or all in the current year). A change from one treatment to the other therefore clearly involves the proper time for the taking of a deduction.

Here, by contrast, Diebold's correction involved not the timing of a deduction, but whether the modules were deductible from gross income at all—or whether, instead, they were to be included in inventory and thus considered in calculating gross income from gross receipts. See Pet. 3 n.2. Moreover, whereas it is often a close question whether an item should be expensed or instead depreciated, there is no question that it is improper to include in inventory items not held for sale. The removal of such items from inventory is merely the correction of a substantive error in miscategorizing an item.[2]

The considerations relevant to the specific correction involved in this case would more appropriately be discussed in a brief on the merits. Suffice it to say that the example in the regulations cited by the government addresses a different situation, and that the decision below has been specifically criticized as reaching an incorrect result. *See* Seago, Horvitz, and Linton, *When Is the Correction of an Error a Change in Taxpayer's Method of Accounting?*, 73 J. Tax'n 76 (1990) ("In *Diebold*, the result appears incorrect.").[3]

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[2] As such, that correction would appear more closely analogous to the examples of corrections of substantive errors cited in Treas. Reg. § 1.446-1(e)(2)(ii)(b). See Pet. 8 n.8.

[3] *See also* 73 J. Tax'n at 79-80 (footnote omitted):

> The taxpayer in *Diebold* lost a substantial investment credit on what would be generally considered a technicality that surely did not serve the purposes of either the investment credit or tax accounting provisions of the Code. Also, Diebold was forced to wait for its income to be recovered through the change in method procedures while the Government enjoyed an interest-free loan.
>
> On the other hand, allowing a taxpayer to correct an erroneous method by filing an amended return would be a step in the

2. The government also attributes to petitioner the contention that, "when a taxpayer changes from an incorrect method of accounting to a correct one, Section 446(e) does not require that he obtain the prior consent of the Commissioner." Br. Opp. 7. That is simply a mischaracterization of petitioner's position. Petitioner makes no claim that § 446(e) is inapplicable whenever the procedure the taxpayer seeks to correct is erroneous.[4] Rather, petitioner contends that § 446(e) does not apply to the correction of a substantive error that would have been improper under any set of accounting procedures.

This distinction explains why the decisions cited by the government at Br. Opp. 8-9 are inapposite. As we noted in our petition, none of those cases "involved a taxpayer who sought to correct a tax treatment that would have been erroneous under any set of accounting procedures." Pet. 8 n.7. The government completely ignores this distinction. In each case cited by the government, the procedure the taxpayer was required to continue to use was one that, if erroneous at all,[5] was erroneous only because of other accounting procedures adopted by the taxpayer.[6]

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direction of simplification. The amended return procedures were created because it was generally recognized that mistakes will be made. It is not apparent why the consequences for mistakes should be so extreme in the case of accounting errors.

[4] Petitioner expressly acknowledged below that § 446(e) can apply "even if the practice the taxpayer seeks to correct was erroneous given the taxpayer's overall method of accounting." Brief for the Appellant, No. 89-1349, at 27 n.24 (citation omitted).

[5] In two of the cases cited by the government, the procedure the taxpayer was required to continue using was not erroneous. *Poorbaugh v. United States*, 423 F.2d 157 (3d Cir. 1970); *Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir.), *cert. denied*, 375 U.S. 879 (1963).

[6] For example, in *Hackensack Water Co. v. United States*, 352 F.2d 807, 809-10 (Ct. Cl. 1965), the procedure the taxpayer sought to change—deducting state property taxes when paid rather than when assessed—was not improper in itself, but was suspect only because the taxpayer otherwise used the accrual method for computing income and expense.

By contrast, there is *no* accounting system under which items not held for sale belong in inventory. We know of no case, other than this one, in which a taxpayer was held to be bound to continue to use a tax treatment that was impermissible under any and all circumstances.

3. The government asserts that the decision below does not conflict with the decisions in *W.A. Holt Co. v. United States*, 368 F.2d 311 (5th Cir. 1966), and *Schuster's Express, Inc. v. Commissioner*, 66 T.C. 588 (1976), *aff'd*, 562 F.2d 39 (2d Cir. 1977), because in those cases the taxpayers' erroneous practices did not amount to a "method of accounting." Br. Opp. 10. But it could just as easily be said that including items not held for sale in inventory is not a "method of accounting." Items not held for sale simply do not meet the substantive definition of inventory. See Pet. 3 n.2.[7]

We noted in our petition that the decision of the Federal Circuit in this case conflicts with several decisions of

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[7] The government suggests that the change here involved "the *timing* of deductions." Br. Opp. 10 (emphasis in original). As noted at page 3, *supra*, the change in fact involved whether the items were (1) to be the basis of a deduction or (2) to be included in inventory and thus considered in calculating gross income from gross receipts.

Moreover, contrary to the government's assertion, the correction at issue in *Holt* did implicate timing, but was nevertheless held not to constitute a change in method of accounting because the original tax treatment was substantively improper. The procedure of charging off bad debts in *Holt* was a reserve procedure which takes deductions for bad debts on a ratable basis, over time, rather than at the time when the debts actually become worthless. The Commissioner rejected this procedure because it allowed the taxpayer to take deductions for accounts that were not in fact worthless. As a result, the Commissioner disallowed deductions in a prior year and thereby increased the taxpayer's income for that year, but increased the taxpayer's deductions and thereby reduced its income in the following year. 368 F.2d at 312. Despite the timing consequences of the correction, the Fifth Circuit held that there was no change in method of accounting, because it is simply improper to write off as a bad debt an account that is not worthless.

the United States Tax Court, which have held that the correction of an error in characterizing an item is not a change in method of accounting. Pet. 7-10 & nn. 9-10. With the exception of *Schuster's Express*, the government does not even discuss the Tax Court cases cited by petitioner. It instead relies on three other Tax Court decisions which it suggests are consistent with the Federal Circuit's decision. Br. Opp. 9 n.4. None of those decisions, however, involved the correction of an error in characterizing an item that would have been impermissible under any accounting system. And none questions the distinction recognized in *Underhill v. Commissioner*, 45 T.C. 489, 496 (1966), between changes intended to reflect the true character of an item and changes in the proper method or time for reporting an item the character of which is not in question. That distinction was recognized and applied by the Tax Court as recently as April of this year. *See Coulter Electronics, Inc. v. Commissioner*, 59 T.C.M. (CCH) 350, 365 (1990), *quoted* at Pet. 9 n.9. By declaring that it is "irrelevant" whether the tax treatment to be corrected would be proper under any accounting method, Pet. App. 6a, the Federal Circuit reached a conclusion in conflict with these Tax Court decisions.[8]

There was and still is a direct conflict between the position of the Tax Court and that of the Federal Circuit as to whether a correction of a substantive error, which would have been improper under any set of accounting procedures, constitutes a change in "method of accounting." Taxpayers who face the question whether there has been a change of accounting method that re-

[8] As we noted in the petition, the Claims Court in this case itself noted the conflict between the caselaw in the Tax Court and the caselaw in the Federal Circuit. Pet. 7 n.7; *see also* Reply Brief for the United States in Support of Its Motion for Summary Judgment 9 (Sept. 14, 1987) ("the Tax Court decisions upon which plaintiff relies do not accurately reflect the law, at least in this circuit") (footnote and citations omitted).

quires the Commissioner's prior approval, or instead a correction of an error that does not require such prior approval, should not be governed by different rules depending on whether the issue arises in the context of a deficiency asserted by the IRS (which would permit the taxpayer to go to the Tax Court), or a suit for a refund (which would deny the taxpayer access to the Tax Court). In view of the recurring nature of the issue, this conflict alone warrants review by this Court, so there can be one uniform rule applicable to all similarly situated taxpayers.

CONCLUSION

For the foregoing reasons, and for the reasons set forth in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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